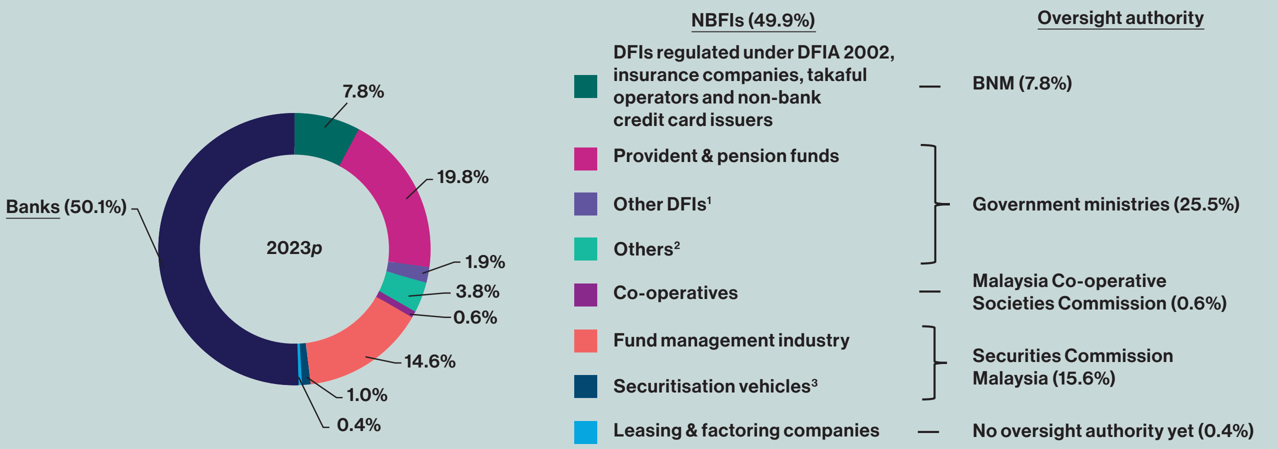
Contagion Risk from Non-Bank Financial Institutions' (NBFI) Activity

The NBFI sector, both globally and domestically, has grown significantly in the past decade

Globally, non-bank financial institutions'[1] (NBFI) financial assets have more than doubled since 2008, reaching USD218 trillion as at 2022. The interlinkages between the NBFI sector with the rest of the financial system have also deepened, in line with the growing significance of NBFIs in the economy. This presents new channels of propagation of financial stress. Recent episodes of financial market stress associated with NBFIs in advanced economies[2] have underlined the importance of monitoring developments in this sector that could give rise to systemic risks, particularly from activities and behaviours during stressed conditions that might amplify financial shocks to the economy.

In Malaysia, the NBFI sector has expanded by 67.4% over the past decade, with total assets growing from RM2 trillion in 2013 to RM3.3 trillion in 2023. NBFI assets as a share of total financial system assets have correspondingly increased from 38.1% to 49.9%. Of this, close to half is held by development financial institutions (DFIs),[3] insurers and takaful operators (ITOs), and investment funds that are prudentially regulated by BNM or the Securities Commission. The structural composition of the sector has been relatively stable over the past decade. Pension and provident funds form the bulk of the remaining share of NBFI assets (Chart 1). Such funds are subject to specific laws, regulations or guidelines issued by the Government or regulatory authorities that govern their management and operations.

Chart 1: Financial System – Composition of Assets



p Preliminary

1 Development financial institutions (DFIs) that are not regulated by BNM under the Development Financial Institution Act (DFIA 2002).

2 Refers to pawn brokers, money lenders, non-bank providers of credit and hire purchase financing, non-bank provider of education financing, non-bank provider of housing credit, government-owned trustee company, and social security organisation.

3 Refers to outstanding asset-backed securities and assets of national mortgage corporation.

Source: Bank Negara Malaysia, Malaysia Co-operative Societies Commission, Securities Commission Malaysia and published financial statements by NBFIs

---

1 Based on the Financial Stability Board (FSB), NBFIs include the broad measure of all non-bank financial entities, composed of all financial institutions that are not central banks, banks, or public financial institutions.

2 Among the notable examples include the "dash-for-cash" episode in the United States in March 2020, the collapse of Archegos Capital Management in March 2021, and the stress in the United Kingdom pension funds sector in September 2022.

3 Refers to DFIs under the Development Financial Institutions Act 2002.

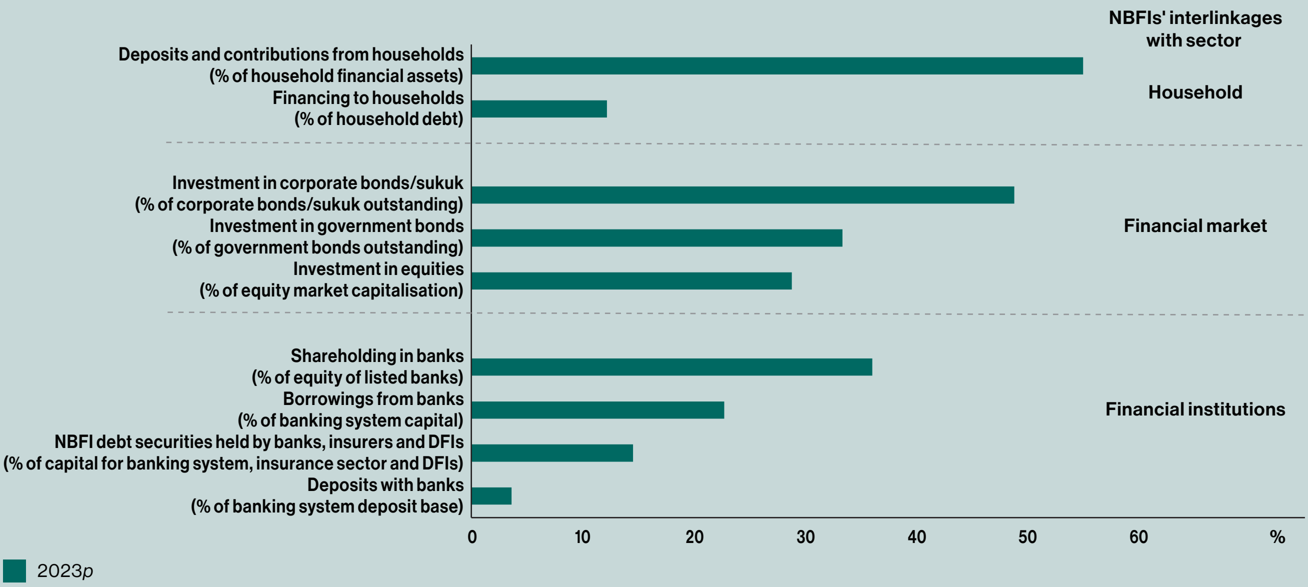
Other non-bank credit intermediaries[4] account for a much smaller share (10.9%) of NBFI assets. Lending by these non-bank credit intermediaries is extended to individual borrowers and typically funded via bank loans, the capital market or government grants, with limited maturity transformation.[5] Their share of credit was at 12.2% of total credit to households, with the balance intermediated by traditional banks. The share of total financial system assets of these entities has remained stable over the years, with generally modest credit expansion observed, consistent with their niche target markets. While some of these non-bank credit intermediaries are currently unregulated, the impending enactment of the Consumer Credit Act (CCA) will pave the way for the establishment of the Consumer Credit Oversight Board as an independent competent authority to oversee consumer credit providers and credit service providers.[6]

NBFIs are interconnected with the banking system, both directly and indirectly

NBFIs[7] exhibit both direct and indirect connections with the banking system:

- NBFIs hold a substantial stake in banks, accounting for 36.1% of the total listed equity of banks (Chart 2). This increases the potential for strains from the NBFI sector to spill over to the broader banking system, and vice versa, through financial and reputational channels. Dividends distributed by banks are also an important source of income for several large NBFIs. A significant fall in the profitability of banks could adversely impact the financial performance of these NBFIs and ultimately, household savings held with NBFIs. This in turn could create negative feedback loops to the banking system and broader economy.
- NBFIs are also large depositors in the banking system, with deposits concentrated in individual banks. For some banks, NBFI deposits account for as much as 17% of their deposit base. As such, large unplanned withdrawals by NBFIs, particularly in response to sudden liquidity needs, could result in subsequent liquidity strains on banks. During the COVID-19 pandemic, the implementation of relief measures[8] led to large deposit withdrawals by some NBFIs to meet an unexpected demand for liquidity. Banks' strong liquidity positions at the time had cushioned the impact, with

Chart 2: Non-Bank Financial Institutions – Interlinkages with the Financial System



p Preliminary

Source: Bank Negara Malaysia, Bloomberg, Malaysia Co-operative Societies Commission, Reuters, Securities Commission Malaysia and published financial statements by NBFIs

4 Includes co-operatives, moneylenders, pawnbrokers, leasing and factoring companies, non-bank providers of housing loans, hire purchase, and student loans.

5 Maturity transformation assesses the extent of maturity gap risk taken by an NBFI and is measured by the coverage ratio of short-term liabilities over short-term assets. The maturity transformation ratio for selected non-bank credit intermediaries ranges from 0.12 times to 0.41 times, which remained below the median maturity transformation ratio for finance companies in other jurisdictions (2022: 0.86 times). (Financial Stability Board, 2023, p. 50).

6 The CCA is expected to be tabled at the Parliament in the third quarter of 2024.

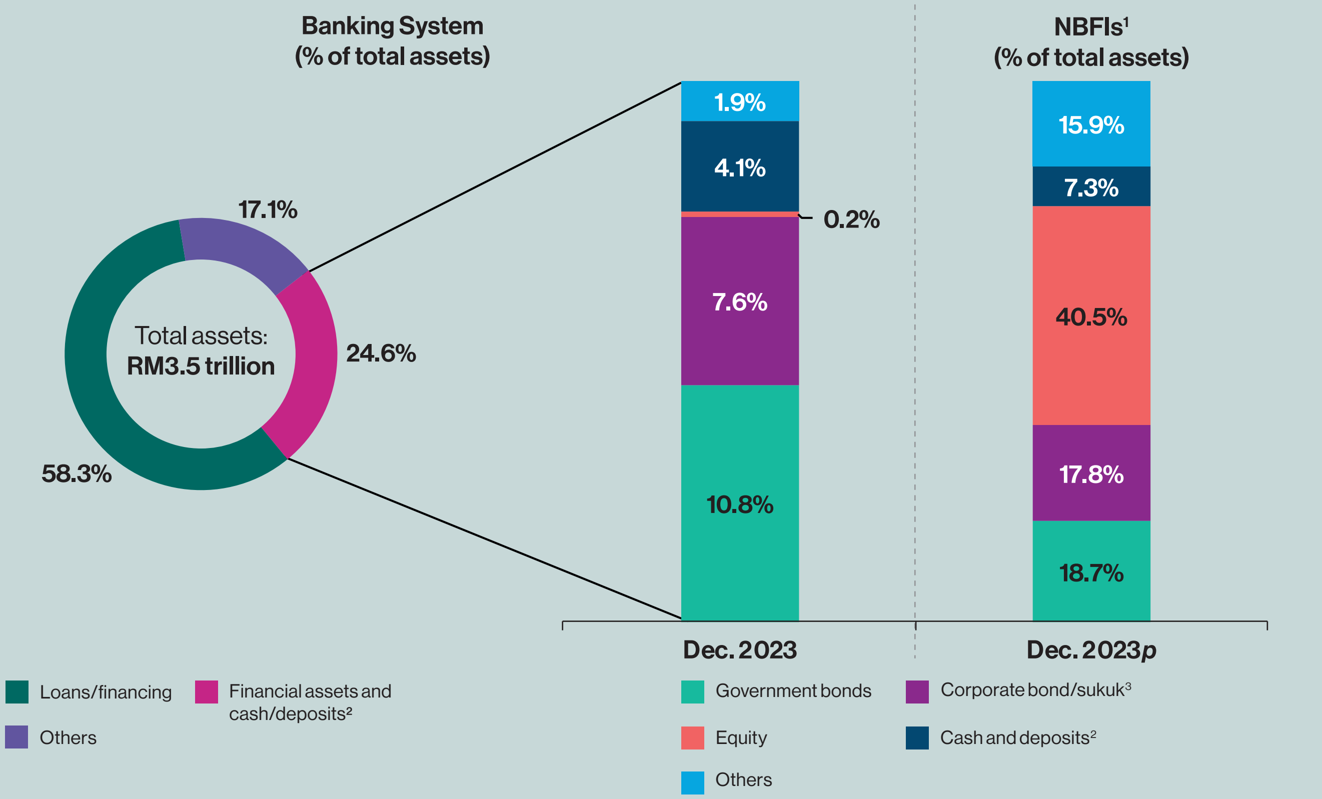
7 In the subsequent section of this box article, references to NBFIs exclude DFIs, ITOs and non-bank credit card issuers that are regulated by BNM. BNM-regulated DFIs, ITOs and non-bank credit card issuers are subject to strong prudential standards that mitigate financial stability risks.

8 The relief measures implemented by NBFIs include lowering the contribution rate and allowing the withdrawal of savings from retirement funds, introducing job protection and hiring incentive programmes, and deferring loan repayments.

the overall Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) remaining well above their minimum requirements.

- Direct contagion risk can also stem from banking institutions' funding to NBFIs, either via loans to or holding of debt securities issued by NBFIs. NBFIs' inability to meet their debt obligations could result in credit losses to banks. At present, such risks are largely mitigated as about half of the credit exposures of banks to NBFIs are guaranteed by the Government, thus minimising potential credit losses to banks if NBFIs face financial distress.
- NBFIs are significant participants in the domestic financial markets, with substantial investments in equities, government bonds and corporate bonds/sukuk (Refer to Chart 2). The common asset holdings between NBFIs and the banking system are primarily concentrated in the government bond markets (Chart 3). While NBFIs' participation in the financial markets provides stability and depth to these markets, any large-scale disposal of these assets by NBFIs under stressed conditions could significantly depress asset prices. This could subsequently affect the balance sheets of banks with similar asset holdings, presenting indirect contagion risks from NBFIs to the banking system. Based on the liquidity profiles of key NBFIs, in the event of sustained stressed outflows faced by these NBFIs that lead to a fire sale of their government bonds and an associated increase in bond yields by up to 53.5 bps, the subsequent contagion risk to banks' solvency is assessed to be minimal. Results from the simulation show that the banking system's total capital ratio as at December 2023 may decline from 18.5% to 18.1% post-simulation.
- While banks and NBFIs also both have sizable holdings of corporate bonds and sukuk, the exposures are more dispersed across various issuers. This significantly reduces the transmission of indirect contagion risk from an asset fire-sale by NBFIs. Similarly, the indirect contagion risk from an equity fire-sale by NBFIs to the banking system is expected to be limited, given that banks have minimal exposure to equity investments (0.2% of total banking system assets).

Chart 3: Asset Allocation in the Banking System and Non-Bank Financial Institutions



p Preliminary

[1] Includes systemic provident and pension funds, systemic unit trust funds, systemic non-bank deposit-taking institutions, non-bank provider of education financing, non-bank provider of housing credit, government-owned trustee company, social security organisation, and national mortgage corporation.

[2] For banks, this comprises cash and cash equivalents, deposits placements and reverse repurchase agreement, and statutory deposits placed with BNM.

[3] Includes debt securities issued by BNM, Cagamas Berhad and Khazanah Nasionah Berhad.

Source: Bank Negara Malaysia

Robust surveillance of the NBFI sector is crucial for the timely detection of potential financial stability risks

Given the important interlinkages between NBFIs and the rest of the financial system, BNM regularly engages the relevant regulatory authorities, such as the Securities Commission and the Malaysia Co-operative Societies Commission, and selected systemic NBFIs as part of its surveillance on financial stability risks that may emerge from the activities of NBFIs. These engagement platforms allow for the sharing of information to enable more integrated risk assessments. Efforts continue to be made to expand the coverage of risk assessments of the NBFI sector through greater data sharing across relevant entities and agencies. Where potential risks to financial stability are identified, the Financial Stability Executive Committee[9] (FSEC) serves as the apex committee empowered to specify policy measures applicable to NBFIs in order to avert or reduce such risks. The last time such measures were taken was in 2013 when macroprudential measures were extended to selected non-bank credit intermediaries to curb excessive household indebtedness and promote the adoption of sound responsible financing standards across the key credit providers.[10]

References

Barr, M. S. (2022, December 1). *Why Bank Capital Matters.* Board of Governors of the Federal Reserve System. https://www.federalreserve.gov/newsevents/speech/barr20221201a.htm

Cetorelli, N., Landoni, M., & Lu, L. (2023). *Non-Bank Financial Institutions and Banks' Fire-Sale Vulnerabilities*. Federal Reserve Board of New York Staff Report No. 1057.

Choudhary, R., Mathur, S., & Wallis, P. (2023). *Leverage, Liquidity and Non-Bank Financial Institutions: Key Lessons from Recent Market Events*. RBA Bulletin - June 2023.

Financial Stability Board. (2023). *Global Monitoring Report on Non-Bank Financial Intermediation.*

International Monetary Fund. (2023). Chapter 2: Nonbank Financial Intermediaries: Vulnerabilities amid Tighter Financial Conditions. In *Global Financial Stability Report: Safeguarding Financial Stability amid High Inflation and Geopolitical Risks.* (pp. 59–80).

Sydow, M., Schilte, Aurore, Covi, G., Deipenbrock, M., Del Vecchio, L., Fiedor, P., Fukker, G., Gehrend, M., Gourdel, R., Grassi, A., Hilberg, B., Kaijser, M., Kaoudis, G., Mingarelli, L., Montagna, M., Piquard, T., Salakhova, D., & Tente, N. (2021). *Shock Amplification in an Interconnected Financial System of Banks and Investment Funds*. ECB Working Paper No. 2021/2581.

---

[9] The FSEC was established in accordance with Section 37 of the Central Bank of Malaysia Act 2009. Refer to the chapter on "Board of Directors, Senior Management, Organisation Structure and Statutory Committees of the Bank" in the BNM Annual Report 2023 for further details.

[10] In 2013, the FSEC decided to extend the responsible financing standards to all credit co-operatives regulated by the Malaysia Co-operative Societies Commission and two large retail credit providers. Among others, the measures included limiting the loan tenures for personal financing and housing loans, and prohibiting the offering of pre-approved personal financing facilities without an application from the borrower. Refer to the BNM Financial Stability and Payment Systems Report 2013 for further details.